

**July 22, 2016**

## MARKET LEVELS

	Friday*	Last week	Dec. 31, 2015	One year ago
Dow Jones Industrial Avg	18,518	18,517	17,425	17,732
S&P 500	2,165	2,162	2,044	2,102
NASDAQ	5,082	5,030	5,007	5,146
Russell 2000	1,203	1,205	1,136	1,245
DJ STOXX Europe 600 (€)	340	338	366	398
Nikkei Index (¥)	16,627	16,498	19,034	20,684
MSCI EM Index	444	441	411	447
Fed Funds Target	0.25%-0.50%	0.25%-0.50%	0.25%-0.50%	0.00%-0.25%
2-Year Treasury Yield	0.71%	0.67%	1.05%	0.70%
10-Year Treasury Yield	1.58%	1.55%	2.27%	2.27%
U.S. \$ / Euro	1.10	1.10	1.09	1.10
U.S. \$ / British Pound	1.31	1.32	1.47	1.55
Yen / U.S. \$	105.97	104.88	120.22	123.93
Gold (\$/oz)	\$1,321.62	\$1,337.50	\$1,061.42	\$1,090.60
Oil	\$43.77	\$45.95	\$37.04	\$48.25

*\*Levels reported as of 7:06 a.m. PDT*

## MARKET RETURNS

**Year-to-date (12/31/15 – 07/22/16)\***

Dow Jones Indus Avg.	7.87%
S&P 500	7.24%
NASDAQ	2.25%
Russell 2000	6.83%
MSCI World Index	2.56%
DJ STOXX Europe 600	-4.47%
MSCI EM Index	7.91%

**Year-to-date (12/31/15 – 07/21/16)**

90 Day T-Bill	0.17%
2-Year Treasury	1.17%
10-Year Treasury	7.35%
ML High Yield Index	12.39%
JPM EMBI Global Diversified	12.45%
JPM Global Hedged	6.63%

*\*Returns reported as of 7:06 a.m. PDT*

## RECAP OF THE WEEK'S ECONOMIC RELEASES

Date	Report	Survey	Actual	Prior	Details
07/20	(UK) ILO Unemployment Rate 3Mths	5.00%	4.90%	5.00%	UK's unemployment rate fell to its lowest level since October 2005.
07/22	(CA) CPI Core YoY	2.00%	2.10%	2.10%	Canadian Core CPI marked its 4th consecutive month above 2%.

## ECONOMIC OVERVIEW

"If only they had tried harder." So went the refrain of academic economists after Japan's frustrated attempts to rid the country of deflation throughout the 1990s and early 2000s. Much hope, then, filled the air when Shinzo Abe (in tandem with BoJ Governor Kuroda) launched a volley of policies arrows meant to defeat deflation. As of July, the Bank of Japan's balance sheet in US dollar terms is nearly as large as the US Federal Reserve's balance sheet (over \$4 trillion). Has it worked? Not really. The Bank of Japan has more than trebled its holdings in the last 5 years and a measure of core inflation, which excludes fresh food, has hardly budged. Core inflation actually fell -0.4% in the last year and is only up 3.6% on a cumulative basis since 2011. Here's the lesson: try as they might, central banks do not have as tight a grip on macro indicators as they (or investors) imagine they do.

## US MARKETS:

### TREASURIES

- Treasuries moved mostly sideways to slightly lower in price as risk-on dominated the markets though volumes and conviction remain quite low. The attempted coup in Turkey caught the market by surprise late last week after yields moved roughly 20 basis points higher the previous 7 sessions.
- The 1.60% level in 10-year Treasuries brought out some buyers fading any corporate bond supply pressures this week. However, without any first tier economic data, the main driver of price action in yields was USDJPY where correlations are close to one-for-one. Mid-week, the market focused on headlines out of global central banks. Governor Kuroda of the Bank of Japan dismissed the idea of implementing helicopter money, and the ECB left everything as-is and hypothesized what the true effect of Brexit would be on the European economy. Treasuries moved in line with German bunds and UK gilts as global curves bear steepened on the central bank news. The curve flattened back to end the week as traders setup for belly supply and crude continued to trade down. Real yields and inflation breakevens cheapened into the new 10-year TIPS auction this week with the auction stop eventually coming through 1 basis point.

### LARGE-CAP EQUITIES

- The U.S. Equity Market rose modestly for the week on strong corporate earnings and increased M&A activity. The positive market sentiment, with very little resistance from the seasonally light trading volumes this time of year, have pushed broad equities (S&P 500) to their fourth consecutive weekly gain.
- The S&P 500 index ended the week up approximately 0.3%, while the Dow Jones Industrial Average closed unchanged. The NASDAQ Composite benefited the most from the upbeat 2nd quarter earnings results as the tech-focused index climbed 1.2% for the week. Large-cap stocks performed in-line with small-cap stocks. In terms of style, large-cap growth stocks outperformed large-cap value stocks. The best performing sectors were info tech and health care, while the worst performing sectors were industrials and energy.

- S&P 500 companies continued to post strong 2nd quarter corporate earnings results as 8 out of every 10 companies (125 companies in total) have topped street earnings estimates. A few notable earnings beat this week include Microsoft, Johnson & Johnson, Bank of America, QUALCOMM and Lockheed Martin.

## **CORPORATE BONDS** \_\_\_\_\_

- The third week of July started with a bang, opening with a \$15 billion Teva deal. The deal had six tranches across the curve, dropping a three year floating tranche along the way. The deal was purposed to finance the acquisition of Actavis's generic business, one of many examples of consolidation in the healthcare industry. As with many large deals, the entire issue priced 30-40 basis points inside of price talk and tightened an additional 10-15 on the days following. Total issuance for the week was expected to be \$30-\$35 billion; it is \$28 billion as of Friday morning.
- In corporate news, the US Department of Justice is planning to challenge the two health insurance mergers on the horizon. In 2015, Anthem purchased Cigna and Aetna bought Humana, and if both transactions are completed, only three large health insurers would remain. DOJ's threat to end both deals follows a string of regulation seeking to crack down on M&A that would violate the spirit of antitrust laws. The Corporate Index Option-Adjusted Spread (OAS) finished the week at +141, five tighter on the week. Overall metals/mining were four tighter; energy was six tighter. Senior and subordinated financials were each two tighter. Industrials were three tighter and utilities were tighter by two.

## **MORTGAGE-BACKED SECURITIES** \_\_\_\_\_

- After outperforming early in the week, Agency mortgages closed on a low note versus US Treasuries. Global central banks failed to offer the stimulus expected by market pundits post-Brexit. Pass-through spreads leaked wider consistent with most fixed income assets as yields rose and volatility picked up.
- Supply outstripped demand as overseas interest waned with weakness in the Japanese yen. Money managers were also net sellers in profit taking from two strong weeks of basis performance. As for prepayments, we expect September's report to represent the peak month to account for the spike in refinance activity last week. In other markets, commercial MBS outperformed alternative risk assets but lagged US Treasuries as swap spreads widened. Deal flow has resumed with the marketing of two conduit and two single asset, single borrower transactions. Interest for commercial real estate has been robust post-Brexit with the thought of strong foreign capital flows into the US market. The spread of 10-year senior class AAA-rated bond versus US Treasuries stands at 100 basis points.
- For the week, the 30-year current coupon versus the 10-year US Treasury leaked wider by two basis points to 81 basis points. According to Freddie Mac, the 30-year mortgage rate edged higher to 3.45%.

## **ASSET-BACKED SECURITIES** \_\_\_\_\_

- Last week's record ABS new issuance was followed with another heavy week of issuance. The results were the same, heavy supply was met by heavier demand. Everything priced at or through the tighter end of price guidance. As an update, the inaugural Verizon smartphone 2.5-year deal is now a S+43/41 market, in from S+55 at initial pricing. For perspective, Capital One priced their 3-year credit card deal at S+38 this week. The new issuer, first time collateral concession did not last long.
- We met with Amy Sze, head of ABS research at JP Morgan this week. In summary, the world is in a safe place for the majority of consumer ABS. Some businesses are quite unique like the SoFi student loan refinance model, taking elite graduate school borrowers with established high salaried jobs and consolidating student loans into lower interest rates with very limited default risk. These borrowers are called HENRYs, High Earners, Not Rich Yets. If you are a HENRY with outstanding FFELP or FDLP student loans, you may want to check out the Sofi site, or if you are a Wharton grad, CommonBond may be for you since it was founded by a couple of Wharton grads.

## MUNICIPAL BONDS

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- Much of the activity this week was focused on a modestly healthy \$7 billion new issue calendar. Further softening in yields over the past week has provided investors with an opportunity to pick up yield after seeing record lows just a few weeks ago. Much of the focus has been concentrated in longer maturities as both traditional and non-traditional buyers lock-in rates. New issuance has also continued to transition to lower coupons as investors resist high premiums of traditional 5% coupons. Bonds carrying coupons of 2.00-4.50% have represented 43% of issuance year-to-date while these coupons represent just 23% of the total market.
- The dominating theme in the municipal market over the past few weeks has been that of low volatility. During multi-day periods of seemingly back and forth Treasury movements, municipal yields alternate between days of outperformance followed by underperformance as they remain steady. This comes as a double edged sword as the comfort of lower volatility can at times come at the expense of short-term opportunities. As we've discussed recently, we anticipate this trend to continue as investor demand remains strong and supply is expected to remain tempered over the near term.

## HIGH-YIELD BONDS

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- The BofA Merrill Lynch BB/B cash pay constrained index was up +0.27% this week as spreads tightened by one basis point to an option-adjusted-spread of +424 basis points. The BofA Merrill Lynch BB/B index that excludes utilities and energy was up +0.35% for an OAS of +406 as the spread of that index tightened by five basis points. The BofA Merrill Lynch Euro BB/B constrained index was up +0.26% as the spread of that index tightened by seven basis points for an OAS of +382.
- High-yield moved higher this week although the pace slowed after the torrid run higher and tighter the past three weeks as mutual fund inflows slowed and new issue activity increased. Despite the flat market performance early in the week it was still difficult to source bonds as dealer inventories are light. Sell-side traders are reluctant to provide liquidity by adding to already unprofitable short positions they been unable to cover as the market marched higher for most of July.
- Fund flows for the week totaled a positive \$332 million as the speed of inflows slowed to a trickle as compared to the torrent of cash that has flowed into the high-yield asset class the prior two weeks which totaled \$6.15 billion. Trading volumes were muted to start the week, but Tuesday saw a surge in volume to \$14.9 billion from \$10.1 billion on Monday. The daily average for 2016 is \$12.8 billion and Tuesday's relatively high volume appears to be misleading as secondary trades for the new investment grade issuance from Teva Pharmaceutical was erroneously included in volume tally for high-yield.
- \$4.4 billion priced across eight tranches in high-yield this week, with just three of those new tranches accounting for \$2.75 billion of the total as NRG Energy and EchoStar/Hughes Satellite Systems brought upsized benchmark deals to market. The most sought after deal of the week was a \$450 million seven-year note issued by Revlon Consumer Products. The maker and marketer of beauty and personal products priced the B3/B+ rated senior notes at a spread of 481 basis points over treasuries to yield 6.25%. The new deal saw robust demand with an order book of \$3.8 billion. The strong interest in the new notes allowed for pricing 50 basis points tighter than initial price talk. The use of proceeds for the new notes is to help fund the acquisition of cosmetic maker Elizabeth Arden.

## INTERNATIONAL MARKETS:

### GLOBAL BONDS AND CURRENCIES

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- Global government bond yields ended almost flat to slightly lower on the week as the mood shifted on the latter part of the week and risk appetite increased following mostly well-received corporate earnings and hopes for continued central bank assistance. Bond markets benefitted from the markets' cautious tone

earlier on the week following a military coup attempt in Turkey, however the nervousness after the failed coup receded. In Europe, European Central Bank (ECB) kept its benchmark main refinancing rate at zero and the deposit rate at -0.4 per cent while maintaining the same level of monthly asset purchases. In his subsequent press conference, President Mario Draghi struck a moderately dovish tone and reiterated he remained willing to use all the stimulatory tools at his disposal if so required. German Bunds moved slightly lower and the yield on the benchmark 10-year note was down by 1 basis points.

- In the UK, negative PMI data for the services and manufacturing sectors supported the Gilts somewhat. The yield on the 10-year note ended 3 basis points lower.
- In the currency markets, US dollar strengthened versus most other crosses. Sterling continued to weaken post-Brexit and came under further pressure following the worsening economic data. The Japanese yen was a standout underperformer, initially weakening on media reports that policymakers are considering stimulus measures at the upper end of the previously forecast ¥10tn-¥20tn range. AUD also finished the week lower versus the US dollar.

## EMERGING-MARKET BONDS

- Emerging market (EM) dollar-pay spreads were largely unchanged at 355 bps over US Treasuries, while local debt yields increased 11 bps to 6.31%. EM currencies were mixed against the dollar with the South African rand (2.4%) and the Polish zloty (1.6%) exhibiting the strongest performance. The Malaysian ringgit (-2.6%) and Russian ruble (-1.4%) underperformed.
- In Turkey, factions within the military launched a failed coup attempt last Friday. The Erdogan government has since reestablished control, declared a three month state of emergency, and moved to fire tens of thousands that are believed to have sympathized with the coup attempt. In light of the political uncertainty, Moody's has put the country's Baa3 rating on review for downgrade. S&P lowered Turkey's rating from BB+ to BB and maintained a 'negative' outlook.
- In the wake of the coup attempt, the central bank of Turkey cut the upper band of its interest rate corridor by 25 bps to 8.75%, it kept its other policy rates unchanged. In other monetary policy developments, Brazil's Ilan Goldfajn hosted his first monetary policy meeting as governor. In line with expectations, the Brazilian central bank (BCB) maintained its policy rate unchanged at 14.25%. Similarly, South Africa's monetary policy committee stood pat at 7%. In its communique, the central bank lowered its inflation and growth forecasts. In Indonesia, the central bank paused, leaving its policy rate at 6.5%. Most analysts had been looking for 25 bps in easing. Official statements following the meeting were interpreted as dovish, with policy makers acknowledging there is further scope for rate cuts.
- Ecuador's Q1-16 GDP print confirmed that the economy has moved into recessionary territory. In the first quarter, GDP registered -3% y/y, led by a plunge in investment spending (-8.9% y/y). Separately, the Peruvian President-elect, Pedro Pablo Kuczynski, announced his cabinet appointments; his economic team will be led by Alfredo Thorne, a respected economist with private sector experience. In ratings news, S&P affirmed Honduras's 'B+' credit rating, but upgraded the country's outlook to 'positive,' citing better fiscal management.

## HIGHLIGHTS OF NEXT WEEK'S ECONOMIC RELEASES

Date	Report	Consensus	Last
07/26	(US) S&P/CS Composite-20 YOY NSA	5.40%	5.44%
	(US) Markit US Composite PMI	--	51.2
	(US) Consumer Confidence Index	95.5	98
	(US) Richmond Fed Manufact. Index	-2	-7

	(US) New Home Sales	560k	551k
07/27	(EC) M3 Money Supply YoY	5.00%	4.90%
	(UK) GDP QoQ	0.50%	0.40%
	(UK) GDP YoY	2.10%	2.00%
	(US) Durable Goods Orders	-1.30%	-2.30%
	(US) FOMC Rate Decision (Upper Bound)	0.50%	0.50%
	(US) FOMC Rate Decision (Lower Bound)	0.25%	0.25%
07/28	(GE) Unemployment Claims Rate SA	6.10%	6.10%
	(EC) Consumer Confidence	-7.9	-7.9
	(US) Kansas City Fed Manf. Activity	--	2
	(JN) Natl CPI Ex Food, Energy YoY	0.50%	0.60%
	(JN) Industrial Production YoY	-3.00%	-0.40%
07/29	(JN) Natl CPI Ex Fresh Food, Energy YoY	0.70%	0.80%
	(EC) Unemployment Rate	10.10%	10.10%
	(EC) GDP SA QoQ	0.30%	0.60%
	(EC) GDP SA YoY	1.50%	1.70%
	(IT) CPI EU Harmonized MoM	-1.90%	0.10%
	(US) GDP Annualized QoQ	2.60%	1.10%
	(CA) Industrial Product Price MoM	--	1.10%
	(US) Personal Consumption	4.10%	1.50%
	(US) GDP Price Index	1.90%	0.40%
	(US) U. of Mich. Sentiment	90.3	89.5